

No. 77-1724

Supreme Court, U. S.

FILED

NOV 20 1978

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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1978

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HARRY G. BURKS, ET AL., PETITIONERS

v.

HOWARD M. LASKER AND IRVING GOLDBERG

---

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE SECOND CIRCUIT

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**BRIEF FOR THE SECURITIES AND EXCHANGE  
COMMISSION AS AMICUS CURIAE**

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**BRIEF FOR THE SECURITIES AND EXCHANGE  
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**QUESTION PRESENTED**

Whether the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, allows a quorum of directors of an investment company to terminate a stockholders' derivative suit if they exercise independent, fully informed and reasonable business judgment.

**INTEREST OF THE SECURITIES AND  
EXCHANGE COMMISSION**

Congress has given the Securities and Exchange Commission responsibility for enforcing the federal securities laws, including the Investment Company Act of 1940. Under that Act, the Commission has "broad regulatory authority over the business prac-

tices of investment companies." *E.I. duPont de Nemours & Co. v. Collins*, 432 U.S. 46, 52-55 (1977). A major purpose of the Act is to protect investment company shareholders against harm flowing from conflicts of interest between a company's shareholders and its directors and investment adviser. In light of that purpose, the Commission, like the court of appeals, is aware of the risk that the statutorily "disinterested" directors of an investment company may be tempted to disregard their fiduciary responsibility to act in the best interests of the shareholders and, instead, to act in the interests of other directors or the company's adviser. That they not do so is particularly important where, as in the present case, they take action to terminate a shareholders' derivative suit brought against other directors and the adviser under the federal securities laws, for such private suits may provide needed redress to injured investors and serve as a "necessary supplement" to the Commission's own enforcement proceedings. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

The court of appeals sought to achieve the statutory objective by holding that disinterested directors may not, under any circumstances, exercise business judgment to terminate a non-frivolous shareholders' derivative suit. But important benefits to shareholders stem from objective and informed participation by disinterested directors in the management of investment companies. The Commission is concerned that the interpretation of the court of appeals will deprive investment companies of those benefits, and will prevent disinterested directors from terminating derivative suits that are injurious to the company and its shareholders.

For the reasons explained below, we believe that the congressional goal of active stewardship by disinterested directors, performing their responsibilities in the best interests of shareholders, can be achieved by applying the traditional business judgment rule within a framework of safeguards. These safeguards would assure that, when disinterested directors take action to terminate a shareholders' derivative suit, they will exercise independent, fully informed and reasonable business judgment for the benefit of the shareholders.

### STATEMENT

This derivative suit was commenced in February 1973 by respondents, two shareholders of Fundamental Investors, Inc., an investment company registered under the Investment Company Act of 1940 (the Act), 15 U.S.C. 80a-1 *et seq.* Respondents brought suit on behalf of the company against several members of its board of directors and its investment adviser. The complaint alleged that the defendants had violated their duties under the Investment Company Act,<sup>1</sup> the Investment Advisers Act of 1940,<sup>2</sup> and the common law in connection with the purchase and retention by the company of \$20 million in Penn Central Transportation Company commercial paper (Pet. App. 26a).

Discovery in the derivative action was stayed for two years while the company pursued its own litigation against the dealer that had sold it the commercial paper. After it had settled that litigation, the company

<sup>1</sup> Section 13a-3, 15 U.S.C. 80a-13(a)(3), and former Section 36, 15 U.S.C. (1970 ed.) 80a-1(a)(35), 54 Stat. 841.

<sup>2</sup> Section 206, 15 U.S.C. 80b-6.

moved to dismiss the derivative action on the ground that five disinterested members of the board of directors had unanimously determined that, in their business judgment, continuation of the derivative action was contrary to the best interests of the company and its shareholders (Pet. App. 27a-28a).<sup>3</sup>

The district court held that, under the business judgment rule first discussed by this Court in *Hawes v. Oakland*, 104 U.S. 450 (1881), a quorum of the directors, if truly disinterested, has authority to terminate a derivative suit that the disinterested directors conclude is contrary to the company's best interests. The court rejected respondents' argument that the policies of the Act preclude the directors from making such a determination (Pet. App. 10a-11a, 12a, 18a).

The court permitted respondents to conduct discovery on the question of the directors' independence (Pet. App. 11a). After completion of discovery, the district court granted summary judgment against respondents, holding that they had failed to present evidence im-

<sup>3</sup> Of the company's 11 directors, six were either named as defendants in the derivative action or affiliated with the defendant investment adviser. The five directors who decided to terminate the derivative suit served as "disinterested" directors, which are required by Section 10 of the Act, 15 U.S.C. 80a-10. These disinterested directors were not named as defendants in the action and had not been involved in the transactions complained of (Pet. App. 4a, 27a-28a). The disinterested directors received legal counsel from Stanley Fuld, retired Chief Judge of the New York Court of Appeals (*id.* at 28a).

Under the company's certificate of incorporation and by-laws, a quorum (defined as one-third of the directors then in office, but not less than three directors) had authority to render business decisions on behalf of the company (Pet. App. 4a & n.1).

peaching the independence of the directors who voted to terminate the suit (*id.* at 18a-23a).<sup>4</sup>

The court of appeals reversed, relying on its interpretation of the policies of the Investment Company Act. In light of the congressional purpose to "eliminate those aspects of the conduct and administration of [mutual] funds which benefited the managers and adversely affected the stockholders," the court concluded that the statute is

designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Pet. App. 31a. The court also concluded that, as a matter of law, "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues" (*id.* at 32a). The court therefore found it unnecessary to consider the findings of the district court on the issue of independence. The court of appeals held that the traditional business judgment rule, applicable to other kinds of corporations, is inapplicable here because of "the unique nature of the investment company and its symbiotic relationship with its investment adviser" (*id.* at 33a n.14).

#### SUMMARY OF ARGUMENT

1. This case calls for the accommodation of two important policies of the Investment Company Act of

<sup>4</sup> Although the district court placed the burden of persuasion on respondents, it observed that even if the disinterested directors were required to prove their independence they have done so in this case (Pet. App. 22a).

1940, 15 U.S.C. 80a-1 *et seq.*, which declares that it is contrary to public policy for investment companies to be managed "in the interest of directors, officers, [or] investment advisers \* \* \* rather than in the interest of \* \* \* security holders." 15 U.S.C. 80a-1 (b) (2). It is therefore essential that a decision by an investment company's directors to terminate a shareholders' derivative action against the directors and the company's investment adviser be examined to ensure that the decision is in the best interests of the shareholders. But Congress also has determined that the investment company's disinterested directors are to serve as "watchdogs" (*Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977)), and they have the primary responsibility for protecting the interests of absent shareholders. If that statutory policy is to be implemented, then a determination by such directors that a derivative action is harmful to the company should not be ignored.

The court of appeals concluded that disinterested directors should never stand in the way of a nonfrivolous derivative suit seeking to vindicate the rights of shareholders. But that approach ignores both the important statutory role to be served by disinterested directors and the possibility that the disinterested directors may be right—that the derivative suit may cause harm to the company (and thus to all shareholders) greater than any possible benefit.

The district court, in contrast, appears to have concluded that courts should accept the determination of the directors to terminate suit so long as they are "independent" of the defendants named in the complaint. That approach also is deficient, because it ignores the

possibility that the disinterested directors, by failing to consider material information or by making a decision that is not a reasonable business judgment, may not have acted in the best interests of the shareholders.

We believe that a proper interpretation of the business judgment rule should give effect to the decision of disinterested directors to terminate a nonfrivolous derivative action only where the district court finds that the directors were independent, fully informed, and acted reasonably. The district court should not dismiss a derivative complaint unless it is satisfied that each of these elements is present, for otherwise a meritorious claim against directors and the adviser may be improperly abandoned and the congressional purpose that investment companies be managed solely for the benefit of shareholders undermined.

2. Shareholder protection does not, however, require that a lawsuit continue where fully informed and independent directors reasonably determine that maintenance of the suit will injure the company. The decision of the court of appeals that disinterested directors may never terminate a derivative action is based on a failure to give proper consideration to the structure and purposes of the Act. Except for suits brought under Section 36(b), a provision not involved here, nothing in the Act deprives the directors of their traditional authority to terminate derivative actions that are harmful to the company. Indeed, Congress has stated that the Act did not intend "to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). Moreover, Congress has determined that the disinterested directors are to serve as watch-

dogs, and "[t]o the extent that they are 'watchdogs,' they should be given the opportunity, not deprived of it." *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 267 (1st Cir.), cert. denied, 414 U.S. 857 (1973).

3. The district court declined to review the reasonableness of the decision of the disinterested directors to abandon this litigation. The failure of the district court to review reasonableness is particularly troublesome because this is a case where "many millions of dollars" are potentially at stake (Pet. App. 32a) and a colorable claim has been asserted. We suggest that the case be remanded for the district court to examine the grounds underlying the conclusion of the disinterested directors that the burdens of the litigation outweigh its benefits. This review does not permit the district court to substitute its views for those of the directors or to hear the case on the merits. Because, however, Congress has determined that management must act in the interest of shareholders, the suit should not be dismissed unless the district court finds that the decision of the directors was a reasonable exercise of business judgment.

### ARGUMENT

IN LIGHT OF THE STATUTORY PURPOSE TO PROTECT SHAREHOLDERS AGAINST CONFLICTS OF INTEREST AND BREACHES OF FIDUCIARY DUTY BY INVESTMENT COMPANY MANAGERS, AN INVESTMENT COMPANY'S DISINTERESTED DIRECTORS MAY TERMINATE A DERIVATIVE SUIT AGAINST OTHER DIRECTORS AND THE COMPANY'S INVESTMENT ADVISER ONLY IF THEIR DECISION IS AN INDEPENDENT, FULLY INFORMED, AND REASONABLE BUSINESS JUDGMENT

The decision of the court of appeals reflects its concern that the disinterested directors of an investment company are not capable of evaluating objectively the

desirability of maintaining a derivative action against their fellow directors and the company's adviser. Although the court was appropriately concerned about shareholder protection, we believe that shareholder protection can best be achieved by applying certain safeguards to the traditional business judgment rule. The business judgment rule, as defined by this Court, is itself a rule of shareholder protection and should not lightly be discarded. See, e.g., *Corbus v. Gold Mining Co.*, 187 U.S. 455, 463 (1903):

The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations.

Although we disagree with the court of appeals' conclusion that the Investment Company Act deprives directors of all authority to terminate derivative litigation, we believe that the Act requires that the business judgment rule be applied in a manner that is consistent with the statutory purpose of protecting shareholders against conflicts of interest and breaches of fiduciary duty. That purpose will be served if the business judgment rule is applied in cases where the directors are truly independent, are fully informed of the material facts, and render a business judgment that is reasonable under all the circumstances.

**A. The Investment Company Act Was Intended to Regulate Conflicts of Interest and Prohibit Breaches of Fiduciary Duty by Investment Company Directors and Advisers**

An investment company is a pool of liquid assets owned by its shareholders. An investment company of the kind involved in this case (a mutual fund) usually is controlled by its investment adviser, an entity that often has its own shareholders. The adviser typically organizes and promotes the mutual fund, provides management services, selects the fund's investments, handles sales of the fund's shares through an affiliated underwriter, and supervises the business operations of the fund. Persons affiliated with the adviser usually serve on the board of directors of the investment company. See generally *Tannenbaum v. Zeller*, 552 F.2d 402, 405-406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).<sup>5</sup>

The Investment Company Act of 1940 is an outgrowth of congressional concern that existing federal and state law was inadequate to protect the owners of investment company shares. In its *Report on the Study of Investment Trusts and Investment Companies*, H.R. Doc. No. 136, 77th Cong. 1st Sess., pt. 3, 2485-2805 (1939), the Commission identified certain pervasive abuses in the industry that called for corrective legislation. These included self-dealing, larceny, and embezzle-

<sup>5</sup> Ordinary business corporations are managed by officers employed directly by the corporation. The adviser of an investment company exercises at least as much control over the fund as internal management in a typical business corporation. This method of organization causes special problems, however; although the primary goal of management should be to maximize the profits of the corporation, the adviser of a mutual fund also is motivated by a desire to maximize its own profits, giving rise to potential conflicts of interest. See *Tannenbaum v. Zeller*, *supra*, 552 F.2d at 405.

ment by mutual fund managers. In short, "the fiduciary concepts historically applicable to the management of funds of others [had] not always been observed." *Id.* at 2486. Based on this experience, Congress concluded that the public interest was adversely affected when investment companies were managed "in the interest of directors, officers, [or] investment advisers \* \* \* rather than in the interest of \* \* \* security holders," and it enacted the Investment Company Act of 1940 "to mitigate and, so far as feasible, to eliminate" such abuses. See Section 1(b) of the Act, 15 U.S.C. 80a-1 (b).

As this Court has recognized, Congress intended the Act to be a pervasive regulatory scheme, imposing necessary controls on company management. See *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 704-705 n.13 (1975).<sup>6</sup> Just as "Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers," *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977), it likewise intended the Investment Company Act to establish federal standards for the directors and officers of investment companies.<sup>7</sup> In enacting the Investment Company Act, Congress declared that the activities of such companies, extending over many states, "make difficult, if not impossible, effective State regulation of such companies in the in-

<sup>6</sup> Questions of internal management usually left to state law, including director qualifications, requirements for the composition of the board, and limitations on the capital structure and dividend policies of the company, are comprehensively regulated by the Act. *Ibid.*

<sup>7</sup> The Investment Company Act and the Investment Advisers Act were enacted as Titles I and II of the same statute.

terest of investors." Section 1(a)(5), 15 U.S.C. 80a-1(a)(5).<sup>8</sup>

Fundamental to the system of shareholder protection envisioned by Congress is Section 10 of the Act, 15 U.S.C. 80a-10, which governs the composition of the investment company's board of directors. As originally enacted in 1940, Section 10 required that at least 40 percent of the directors not be officers or employees of the company or affiliates of its adviser. 54 Stat. 806. Congress conceived of these unaffiliated directors as "watchdogs" (*Tannenbaum v. Zeller, supra*, 552 F.2d at 406) necessary to "furnish an independent check upon the management" of investment companies. Hearings on H.R. 10065 *Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940).<sup>9</sup>

After passage of the Act, the mutual fund industry grew dramatically.<sup>10</sup> That growth brought with it renewed concern regarding conflicts of interest and shareholder protection. The Wharton Report, *A Study of Mutual Funds*, submitted to Congress by the Commission, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 34-35, 64 (1962), found serious deficiencies in the performance of unaffiliated directors in protecting the

<sup>8</sup> See also 86 Cong. Rec. 2844 (1940) (remarks of Sen. Wagner).

<sup>9</sup> Another provision enacted to regulate conflicts of interest is Section 17, 15 U.S.C. 80a-17, which forbids certain self-dealing transactions without prior approval by the Commission. See *E. I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46, 53-54 (1977).

<sup>10</sup> In 1940 the investment company industry had assets of approximately \$2 billion, with mutual funds having assets of less than \$450 million. By 1967 the industry's assets exceeded \$50 billion, of which \$45 billion were held by mutual funds. *Hearings on H.R. 9510 Before the Subcommittee of the Committee on Interstate and Foreign Commerce*, 90th Cong., 1st Sess. 27-28 (1967).

interests of shareholders. That study was followed by the Commission's *Report on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 30-31, 65-72, 135-149 (1966), which identified serious continuing problems with respect to advisory fees, sales compensation and brokerage practices.

At the recommendation of the Commission, Congress amended the Act in 1970 to strengthen the independence of the "watchdog" directors. Section 2(a)(19) of the Act, 15 U.S.C. 80a-2(a)(19), defines the new term "interested person" to include anyone who has a close relationship with the investment adviser or its affiliates through employment, stock ownership, substantial business or professional relationships, blood or marriage. In Section 10 this new term was substituted for the narrower term "affiliated person" so that at least 40 percent of the board of directors of the investment company must be composed of persons who are not "interested" within the new definition.

Congress also strengthened the fiduciary duty standards imposed under the Act. The Act now authorizes redress for "breach of fiduciary duty involving personal misconduct" (Section 36(a), 15 U.S.C. (1970 ed.) 80a-35(a)) whereas until 1970 it applied only to "gross misconduct or gross abuse of trust." 54 Stat. 841. The new standard permits courts "to deal flexibly and adequately with wrongdoing by certain affiliated persons of investment companies." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 36-37 (1970). And under the new Section 36(b), 15 U.S.C. (1970 ed.) 80a-35(b), the investment company adviser has a "fiduciary duty with respect to the receipt of compensation for ser-

vices," and the Commission and shareholders have a cause of action in federal court to contest compensation deemed to be excessive.<sup>11</sup>

The continuing concern of Congress, reflected in the Investment Company Act, has been protection of shareholders against conflicts of interest and breaches of fiduciary duty by directors and advisers. As we discuss below, this policy has a direct bearing on the proper application of the business judgment rule in derivative actions of this kind.

**B. A Decision by Disinterested Directors to Terminate a Derivative Suit Must Comply with Standards of Fiduciary Duty Required by the Investment Company Act**

In light of the fiduciary obligations imposed by Section 36(a), 15 U.S.C. (1970 ed.) 80a-35(a), and the congressional intent that disinterested directors serve as an "independent check on management," we believe that the Act should be interpreted to require that a decision to terminate a derivative suit against the company's directors and adviser meet certain minimum standards. We submit that the decision to terminate the suit should be given effect only if:

(1) The decision of the disinterested directors is in fact independent and not influenced by the interested directors or the fund's adviser.

<sup>11</sup> Congress also amended Section 15(c), 15 U.S.C. 80a-15(c), which governs the approval of advisory and underwriting contracts between the company and its adviser and principal underwriter. The amended provision requires approval of these contracts by the disinterested directors, requires attendance of the disinterested directors at meetings where votes are taken on such contracts and requires investment advisers to furnish directors with all information reasonably necessary to evaluate the adviser's contract.

(2) The decision of the disinterested directors is based on a consideration of all material facts relevant to the decision.

(3) The decision is reasonably based on the conclusion that the benefits to the company resulting from the suit are outweighed by the disadvantages.

This three-part test was discussed and adopted by the Second Circuit in *Tannenbaum v. Zeller*, *supra*, a case dealing with the discretion of directors under the Investment Company Act to establish brokerage practices for the fund. Although we agree with the *Tannenbaum* court that these rules are called for by the policies of the Investment Company Act, they also have many antecedents in the common law.

This Court recognized long ago that a decision of a company's directors to terminate a derivative action would not be given effect if the directors were dominated or influenced by the alleged wrongdoers or subject to a conflict of interest. See, e.g., *United Copper Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917); *Delaware & Hudson Co. v. Albany & Susquehanna Co.*, 213 U.S. 435, 451-453 (1909). See also Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 193-194 (1976). This Court also has recognized the importance of bringing material information to the attention of the directors; it has required the derivative plaintiff to make a specific demand on the directors and to allow them to give careful consideration to the information presented. See, e.g., *Hawes v. Oakland*, 104 U.S. 450, 461 (1881). See also *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 266-267 (1st Cir.), cert. denied, 414 U.S. 857 (1973); *Halprin v.*

*Babbitt*, 303 F.2d 138, 141 (1st Cir. 1962). Finally, this Court has recognized that the directors may not terminate a derivative action if their decision constitutes a breach of duty. See, e.g., *Hill v. Wallace*, 259 U.S. 44, 61 (1922); *Ashwander v. TVA*, 297 U.S. 288, 319-320 (1936); *United Copper Co. v. Amalgamated Copper Co.*, *supra*. See also Note, *Demand in Derivative Suits*, 73 Harv. L. Rev. 746, 759-760 (1960); Comment, *supra*, 44 U. Chi. L. Rev. at 195-196.

These common law principles reinforce the principles of the Act, and they lead inescapably to the requirements that we discuss below.<sup>12</sup>

**1. The directors must be independent and able to exercise unbiased judgment on behalf of the shareholders**

The independence requirement assures that the directors making the decision to terminate the derivative suit are in a position to carry out their fiduciary responsibilities in the best interests of the shareholders. Because the pleadings usually are insufficient to permit a court reliably to determine whether particular directors in fact are independent, it is appropriate for a court to allow limited discovery on this issue, as the district court did in the present case. See *Gall v. Exxon*, 418 F. Supp. 508, 519-520 (S.D.N.Y. 1976); *Bernstein v. Mediobanca Banca di Credito Finanziario-So-*

<sup>12</sup> Because the claims in the present case are based on federal law, the policies of federal law are significant in interpreting the judge-made business judgment doctrine. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 380-385 (1970); cf. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). The common law, interpreted "remedially," "reinforces" the analysis (*SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

*cieta Per Azioni*, 69 F.R.D. 592, 598 (S.D.N.Y. 1974); Comment, 44 U. Chi. L. Rev., *supra*, at 198-200. The court should carefully scrutinize the facts to assure the actual independence of the decision-makers from those parties charged as wrongdoers in the derivative complaint.

The fact that the interested directors who are defendants in the action constitute a majority of the board is a relevant consideration in determining whether the disinterested directors have acted objectively. The concern of the court of appeals—that directors may be disinclined to permit suit against their colleagues despite their "watchdog" status (see Pet. App. 32a-33a)—is legitimate, and it calls for close attention to the independence issue. Cf. *In re Kauffman Mutual Fund Actions*, *supra*, 479 F.2d at 268-269 (Coffin, J., concurring). Indeed, we believe that it calls for placing on the parties seeking termination the burden of proof to establish independence. Particularly where, as here, a majority of the board of directors are defendants named in the complaint, and the disinterested directors are nominated to serve as directors by that same majority, a potential conflict of interest exists that justifies placing the burden of proof with respect to the issue of independence on the parties seeking termination. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921). The disinterested directors should be required to show that their judgment was in fact independent.

**2. The disinterested directors must be fully informed of the facts relevant to their decision**

The district court also should inquire whether the disinterested directors were informed of the facts relevant to their decision. The court should be satisfied that there has been full disclosure of all relevant facts to the disinterested directors by the interested directors and the adviser. The Commission set forth the basic requirement of disclosure to unaffiliated directors in *Imperial Financial Services, Inc.*, CCH Fed. Sec. L. Rep. ¶ 77,287, at 82,464 [1964-1966 Transfer Binder]:

The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company.

*Moses v. Burgin*, 445 F.2d 369, 376-377 (1st Cir.), cert. denied, 404 U.S. 994 (1971), held that the Act imposes on the adviser and the interested directors a duty of full disclosure, explaining: "If management does not keep these [unaffiliated] directors informed, they will not be in a position to exercise the independent judgment that Congress clearly intended." See also *Tannenbaum v. Zeller*, *supra*, 552 F.2d at 407, 417-418, 426-427; *Fogel v. Chestnutt*, 533 F.2d 731, 749-750 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).

Information so disclosed must, of course, be considered by the disinterested directors with the high degree of care that its importance requires.<sup>13</sup> See *Tan-*

<sup>13</sup> It has long been held that directors of banks, life insurance companies, and similar financial institutions, are under an especially high standard of fiduciary care toward the money they manage. See, e.g., *Goodwin v.*

*nenbaum v. Zeller*, *supra*, 552 F.2d at 418-419; *Brown v. Bullock*, 294 F.2d 415, 421-422 (2d Cir. 1961).<sup>14</sup>

**3. The decision must constitute a reasonable exercise of business judgment**

Because the statutory purpose of the disinterested directors is to protect the interests of absent shareholders in accordance with the fiduciary standards of Section 36(a), the district court should review the reasonableness of their decision to terminate the suit.<sup>15</sup> See *Hill v. Wallace*, *supra*, 259 U.S. at 61; *Ashwander v. TVA*, *supra*, 297 U.S. at 319-320; Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, *supra*, at 196. The test

is not whether, as a matter of hindsight, the determination of the independent directors was correct. The question is whether the decisions \* \* \* were reasonable under the circumstances in which they were reached.

*Tannenbaum v. Zeller*, *supra*, 552 F.2d at 428. The factors weighed by the directors and the basis for giving weight to each of them should be reviewed to determine whether there is a reasonable basis for con-

*Simpson*, 292 Mass. 148, 197 N.E. 628 (1935); *O'Connor v. First National Investors' Corp.*, 163 Va. 908, 177 S.E. 852 (1935); *Hun v. Cary*, 82 N.Y. 65, 71 (1880). The standard of care here should be no less.

<sup>14</sup> The practice of obtaining special outside counsel to assist the directors in analyzing the information presented is an appropriate one. *Tannenbaum v. Zeller*, *supra*, 552 F.2d at 428.

<sup>15</sup> The district court serves a similar role in derivative litigation by reviewing the reasonableness of any settlement that would terminate the suit. See 3B J. Moore, *Federal Practice* ¶ 23.1.24[2] at 23.1-137 to 23.1-139 (1976 ed.).

cluding that the disadvantages resulting from the suit outweigh the advantages.<sup>16</sup>

**C. The Investment Company Act Does Not Divest Directors of All Authority To Terminate Derivative Litigation**

The court of appeals held that the policies of the Investment Company Act preclude disinterested directors from exercising their business judgment under any circumstances to terminate a derivative action of this kind. We believe that the court's conclusion is based on a failure to give proper consideration to the structure and purposes of the Act.

1. The court of appeals appears to have relied on the fact that the Act does not specifically grant the disinterested directors authority to terminate ongoing derivative litigation. But the Act does not purport to withdraw such powers either, and it does not set out every duty and power of such directors. When Congress intended to eliminate the authority of the company's directors under the Act, it did so expressly. For example, Section 17, 15 U.S.C. 80a-17, expressly removed the authority of the disinterested directors to approve certain self-dealing transactions, and Section 36(b), 15 U.S.C. (1970 ed.) 80a-35(b), authorized shareholder actions to challenge the fairness of compen-

<sup>16</sup> The district court might appropriately review the director's judgment under the standards used for review of federal administrative action: courts scrutinize the record for a reasoned determination but do not substitute their judgment for that of the agency. See *United States v. Florida East Coast Ry.*, 410 U.S. 224 (1973); *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971).

sation agreements between the fund and its adviser regardless of the views of the directors.<sup>17</sup>

Although Congress could have prohibited the disinterested directors from exercising business judgment in the circumstances of this case, it did not do so. Indeed, the Senate Report on the 1970 amendments, in discussing Section 36(b), stresses that Congress did not intend the legislation to strip the directors of their traditional business discretion:

[T]he section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. \* \* \* [It] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). Thus, there is nothing in the language of the Act or its history that requires the result reached by the court of appeals.

2. In nullifying the discretion of the disinterested directors in this case, the court of appeals also may have overlooked the choice of Congress to rely on such directors to serve as watchdogs for the benefit of absent shareholders. Congress selected the independent director requirement instead of more drastic remedies such as complete internalization of management or disaffiliation of the company from its adviser. The Commission emphasized to Congress in 1966 that "unaffiliated directors \* \* \* can and should play an active role in rep-

<sup>17</sup> See also Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), which authorizes shareholder suits to recover insider "short swing" profits on behalf of the company notwithstanding the decision of the board of directors not to sue (*Benisch v. Cameron*, 81 F. Supp. 882, 884 (S.D.N.Y. 1948)).

representing the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders."

*Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, *supra*, at 147-148 (1966); (footnote omitted). The premise of the court of appeals—that disinterested directors are incapable of acting independently for the benefit of shareholders—conflicts with the congressional determination in 1970 that such directors are to "supply an independent check on management and to provide a means for the representation of shareholder interests." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

3. We also believe that the court of appeals did not fully consider the fact that the business judgment rule—applied within the guidelines discussed at pages 14-20, *supra*—is itself an important shareholder protection device. Some suits may cost more than they are worth. If the directors properly determine that the suit is injurious to the company, then shareholder protection does not require that it continue. See *Hawes v. Oakland*, *supra*, 104 U.S. at 457-462; *Corbus v. Gold Mining Co.*, *supra*, 187 U.S. at 463; *United Copper Co. v. Amalgamated Copper Co.*, *supra*, 244 U.S. at 263-264; *Ashwander v. TVA*, *supra*, 297 U.S. at 343 (Brandeis, J., concurring); *Swanson v. Traer*, 354 U.S. 114, 116-117 (1957).

This principle applies to investment companies, which may have thousands of shareholders with diverse opinions about the advisability of pursuing litigation

against a variety of defendants. See *In re Kauffman Mutual Fund Actions*, *supra*, 479 F.2d at 266-267:

Normally self-dealing by any corporate director is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. In order to make sure that the directorate not be top-heavy, it provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. All disinterested directors must "act honestly and according to their best judgment for the interests of all." \* \* \* When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with "full knowledge" of the basis for the claim \* \* \* it is for the directors, who have "the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure" to decide on the appropriate corporate response. \* \* \* To the extent that they are "watchdogs" they should be given the opportunity, not deprived of it.

4. Although we therefore disagree with the court of appeals, and agree with the district court, about the availability of the business judgment rule in derivative suits of this kind, we do not believe that the district court applied the rule correctly.

We do not question the district court's finding that the disinterested directors were in fact independent (Pet. App. 18a-23a). And, although the district court did not explicitly consider the question whether the disinterested directors were adequately informed of the material facts, it is clear from the district court's dis-

cussion that the directors were informed and duly considered the relevant information.

The district court's failure to review the reasonableness of the decision of the disinterested directors is more troublesome, particularly because the stakes of the case are quite large<sup>18</sup> and it is asserted that the defendants made no "independent investigation of Penn Central's financial situation before the fund's purchase of the notes" (Pet. App. 26a).<sup>19</sup> The district court nevertheless declined to consider the reasonableness of the directors' conclusion that respondents' claim of breach of fiduciary duty is feeble, and it also appeared to accept at face value the directors' conclusion that disruption and expense resulting from the litigation outweighed any possible recovery (Pet. App. 5a-6a, 11a).

We therefore suggest that the case be remanded so that the district court may consider the reasonableness of the directors' decision to abandon the suit. Although we do not believe that the district court should substitute its judgment for that of the directors, a review of the reasonableness of the directors' views about the relative advantages<sup>20</sup> and disadvantages of the litiga-

<sup>18</sup> See Pet. App. 32a. The complaint in this case alleged investment losses of \$20,000,000. Of this amount, \$5,250,000 in cash and an interest in the potential proceeds of the Penn Central reorganization proceedings were recovered through settlement of the claim against the commercial paper dealer. A. 41

<sup>19</sup> During the period that the Penn Central commercial paper was held in the investment company's portfolio, the financial losses of Penn Central, which led to bankruptcy in June 1970, were "widely reported in the financial press." See *University Hill Foundation v. Goldman Sachs & Co.*, 422 F. Supp. 879, 889-890 (S.D.N.Y. 1976). See also Pet. App. 26a; A. 97, A. 100, A. 102.

<sup>20</sup> An assessment of the advantages of the litigation necessarily must include an assessment of the probable merit of the claim, for that strongly influences the expected benefits of pressing the suit.

tion, based on the information before them at the time of their decision, would not involve the court in such a substitution.<sup>21</sup>

### CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded to the district court for further proceedings.

Respectfully submitted.

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NOVEMBER 1978

<sup>21</sup> Although we suggest a remand, this Court could determine reasonableness if it wishes, because that determination involves only the application of a legal standard to a documentary record.